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# DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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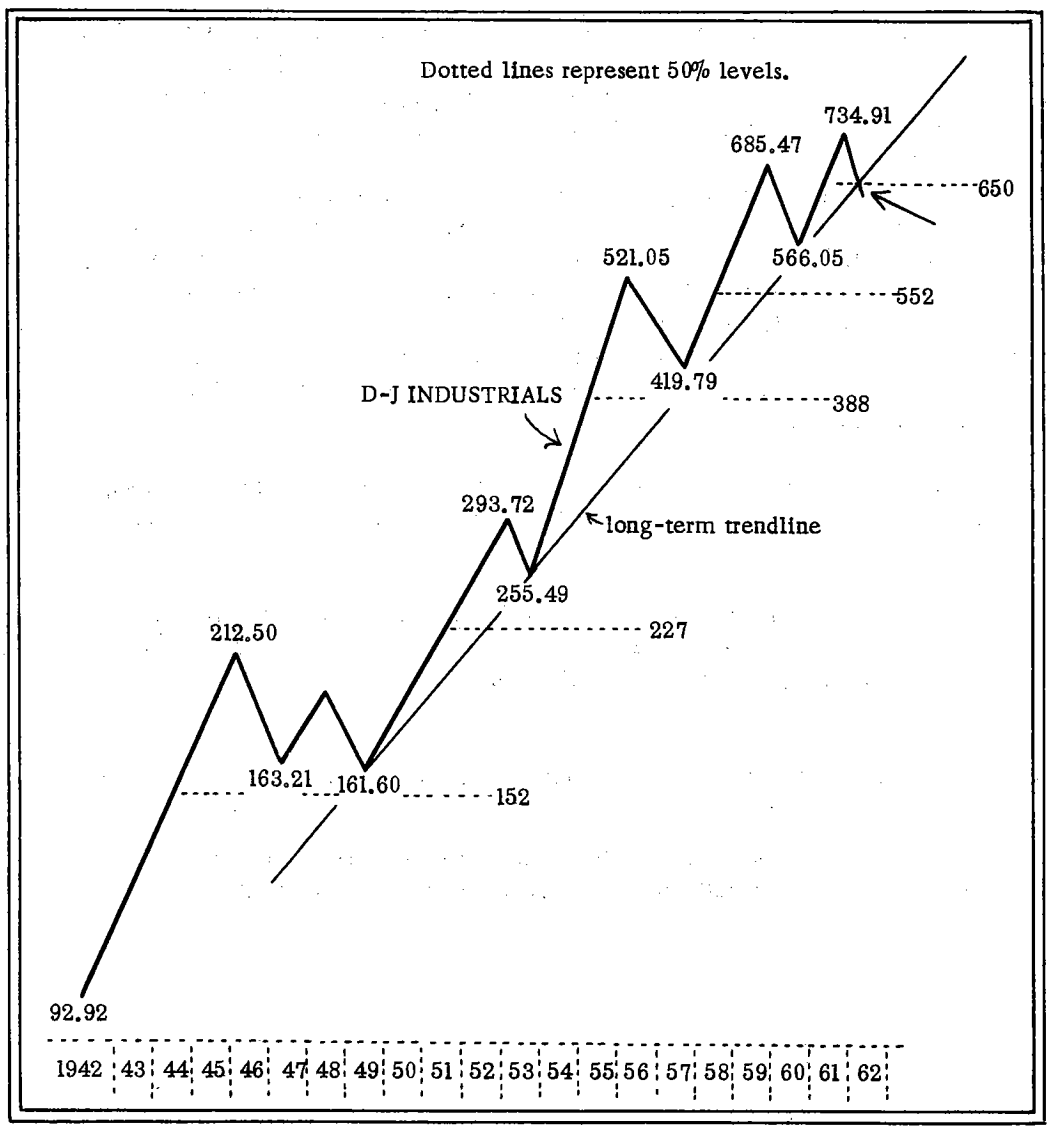
THE MARKET On May 10 the D-J Industrial Average did something which it has not done in twenty years. The Average broke below the halfway or 50% level of a preceding major advance.

As seen on the chart, the extended bull market rises of 1942-46, 1947-48, 1949-53, 1953-57, and 1957-60 were each followed by a major correction. On each and every one of these corrections the Industrial Average was able to hold above the halfway or 50% level of the preceding major advance. The refusal to penetrate the halfway level held continuing long-term bullish connotations and suggested that the major upward force had not been terminated.

The 50% Principle was first put forth by Charles Dow, and I have always attached a great deal of importance to this concept. The following is a quote from Dow's original writing:

> "It is a remarkable fact in speculation that both the average price of a number of stocks and the price of individual stocks show strong tendencies, both in rallies and relapses, to reach one-half of the primary movement. When a stock falls ten points in a comparatively direct movement, it is extremely likely to rally as much as five points from the lowest. It often rallies or relapses more than half of the original swing, but it is generally safe to wait for about half.
>
> A comparison of the Averages... shows how regularly this movement occurs. When a recovery does not come near being one-half of a decline, it generally means that the primary movement has not been completed and that a new low quotation will be made."

In other words, if a recovery cannot make up better than 50% of the preceding decline, one can assume that the downward force is still in effect. Conversely, if a decline can hold 50% or better of the previous advance, it is safe to assume that the upward force is still in effect.



Under the 50% concept, the upward force (see chart) has been undeniably in effect since 1942. Never since that time has a decline succeeded in wiping out more than 50% of the preceding major advance. On May 10 the decline which began on the Industrial Average in December, 1961 broke below the 650 level of the 1960-61 advance. Thus, for the first time since 1942, the 50% principle has turned bearish.

Perhaps coincidentally, the long-term trendline connecting all reaction bottoms on the Industrial Average since 1949 also now stands at 650. This thirteen year trendline has not been penetrated on any of the major declines since 1949. The May 10 action succeeded in taking the Industrial Average below the major trendline for the first time.

Four times since 1949 (1953, 1957, 1960, 1962) the Industrial and Rail Averages have penetrated preceding secondary low points. Each of these joint penetrations conformed to classic Dow Theory bear signals. In the first three instances the declines fell so short of major bear markets (each held above the 50% level) as to resemble severe secondary reactions rather than true liquidating bear markets. Each of the first three penetrations was followed in due time by new highs on the Industrial Average. The market often provides its own irony. The bear signal given by the Averages most recently has largely been ignored by the professional fraternity. In an attempt to provide readers with a final critical "test" of the market, I emphasized the single gauge that has held bullish since 1949 -- the 50% Principle. The difference in downside points from the time of the bear signal to the breaking of the 50% level (650) was 3%. If this is the "bitter end", that 3% may appear insignificant in the light of history.

Hamilton and Rhea in all their writings always stressed a bear point beyond which they considered it foolhardy to carry securities. At Wednesday's closing (May 9) of 647.23, I felt that point had arrived (see Letter 179). I do not pretend to know what we are now heading into, either from a financial or social standpoint. But I have "cleaned house" and am now unwilling to hold negotiable securities of any type. It is my opinion that bulls are now living on "hopes and wishes." Hopes and wishes have materialized many times in the past -- and they may materialize again. They are, however, not enough for this market student.

Neither Dow's Theory nor any other theory can predict the extent or duration of a primary swing. Those who now pretend to "see" support levels for the Averages, if other bear markets are any criterion, are "whistling in the dark." During a primary bear (or bull) swing the market stops at levels of its own making. The 1929 levels were below anything the most rabid bears could foresee. The bear market of 1899, on the other hand, was surprisingly mild.

The market, as of the last letter (179), was technically as "strong" as any seen since 1949. It now seems that the "since 1949" (or bull market) gauge was the wrong one. Ten thousand odd-lot shorts came into the market on May 1. An unprecedented twelve thousand odd-lotters shorted the market on May 10. Following each of these days the market broke easily to lower levels. This writer is reminded of the fact (long tucked away in my mind) that in January, 1931, the total short position rose to a whopping 3.1 million shares. Yet that year proved to be a disaster. When the primary trend is down the shorts are not the factor for technical strength that they are in a bull market. For in a bear market, shorts are "invested" with the primary trend. At such times the shorts (instead of halting the downward swings) merely add to the intensity of the sporadic corrective rallies.

So far we have had a bad market but not a chaotic one. The writer wonders how long stocks can continue their downward path without bringing on one of the sweeping, "bidless" panics that have characterized so many bear market declines of the past.

Short positions in a bear market should be assumed after major corrective rallies halt and become "dull." There should be a number of such advances before the current affair has ended. The purchasing power of cash has been rallying strongly. If the drop continues, the lowly dollar may well come back into style.

(Written May 14, 11:00 a.m. New York time -- with the tape 20 minutes late and Industrials down nine dollars).

Note: Gold stocks traditionally make their upward move during rallies in a bear market. Dome Mines looks outstanding and will give a clear "buy signal" (although it is now strongly bullish) at 29.